WEEKLY MARKET REVIEW

Week ended April 3rd

Stocks Rise on New Accounting Rules, Policy Responses

By Dr. Jerry Webman, Ph.D, CFA
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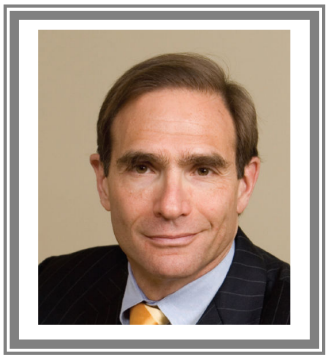
Stocks rose once again last week, buoyed by the apparent success of the G20 summit in London, a relaxation of mark-to-market accounting rules and the government's massive, ongoing policy responses to the financial crisis. While I'm as happy as anyone to see the markets heading higher, I'd caution investors against collectively going from near-despair to euphoria in the space of three or four weeks. The financial system still has a lot of problems to work through.

As Chairman Bernanke said over the weekend, the spring is bringing forth some "green shoots" in the economy. For example, **pending home sales** rose 2.1% in February, according to a report released last week. The Fed's efforts in lowering mortgage rates and making housing more affordable than at any time on record seemingly contributed to the gains. In a similar vein, **construction spending** fell less in February (–0.9%) than in January (–3.3%), led by an increase in public-works projects funded by dollars from the American Recovery and Reinvestment Plan.

Yet, as as the markets grow more enthused about slight improvements in some key economic indicators, it is worth considering what likely *hasn't* bottomed:

- **Employment** 663,000 more Americans lost their jobs in March, following losses of 651,000 and 741,000 in February and January, respectively. Meanwhile, the unemployment rate ticked up to 8.5% in March—a 25-year high—from 8.1% the previous month.
- **Home prices** The S&P/Case-Shiller index of home prices in 20 U.S. cities dropped –18.97% in January, the latest measuring period. The national supply of homes remains well above historical averages indicating that there could be more pressure on prices in the months ahead, despite the fact that we are already three years into a housing depression.

- **Consumer confidence** The Conference Board's Consumer Confidence index remains near record lows, having inched to 26 in March from an all-time low of 25 in February



Dr. Jerry Webman is Chief Economist for OppenheimerFunds, Inc. In this capacity, Dr. Webman provides strategic viewpoints on the overall financial and economic markets to investment management and the financial advisor and investor communities.

For over 20 years, Dr. Webman has been involved in the investment and economic markets—as a researcher, a financial advisor and a portfolio manager.

Dr. Webman holds a B.A. in political science, with honors, from the University of Chicago, where he graduated Phi Beta Kappa, and a Ph.D. in political science from Yale University. He is also a Chartered Financial Analyst.

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In addition, about $20 trillion in household net worth has been destroyed, 5.1 million U.S. jobs have been lost since the recession began in December 2007 and the solvency of many of our nation's banks remains in question. The stock market may be sniffing out future improvement, but for a recovery to be really credible, we'll need to see more concrete evidence.

Relaxed accounting rules may aid banks at the cost of transparency

Bank stocks got a boost last week after the Financial Accounting Standards Board (FASB) decided to relax so-called "mark to market" accounting rules. The practices defined under FASB 115 and 157 have been much-maligned during the recent credit crisis. Banks and other financial entities have been forced to write-down the values of tradable portfolio securities, including mortgage-backed securities, held on their balance sheets to market levels with no regard to whether the market was trading in a disorderly manner or whether the latest trades were the results of forced liquidations by other entities. When such assets became distressed or impaired (e.g., by missing an interest payment) and markets froze, as they have in this financial crisis, banks were forced to value such holdings at fire-sale prices. This process reduced the capital banks held and thus restricted the amounts they were legally able to lend—a problematic result, given the financial system's desperate need for lending to restart.

Following intense political pressure, the FASB ruled last week that banks may now value these securities (though not whole loans) using the estimated present value of the cash flows they produce, rather than their current market prices. To take advantage of this ruling, a bank would have to demonstrate to their auditors that the market for a given security was, in fact, distressed and that a "realistic" price for the security could not therefore be established via the market.

1. FASB 157: Inactive Markets and Distressed Transactions

New FASB Staff Position*:* FASB provided additional guidance in determining fair value of tradable portfolio securities in markets deemed inactive or in markets where prices are at unreasonably low levels as a result of distressed selling. In such instances, companies can value the securities using the present value of the expected cash flow rather than the market-based price. The onus is on the company holding the tradable securities to prove that the market is distressed.

WEEKLY MARKET REVIEW

Week ended April 3rd

2. FASB 115: Impairment Model for Marketable Debt Securities

New FASB Staff Position: FASB determined that in the case of debt holders that do not intend to sell an impaired security, then only the portion of the impairment due to credit deterioration (as opposed to market illiquidity) is charged against earnings. The rest of the impairment is charged to "other comprehensive income," which is not held against regulatory capital. For regulatory capital purposes, the impairment charge is now equal to par value minus the present value of the expected cash flows rather than par value minus market value.

The revisions to FASB 115 and 157 should give a boost to the profits of financial companies. More importantly, it should take the pressure off of them to raise funds to fill holes in their capital created by the original rule and potentially increase lending.

However, since investors will likely be skeptical about these "fair" values, maintaining them may only prolong the recapitalization process. Recording assets at other values does not change the murky economics of the situation but rather hides reality, increases uncertainty, and keeps private capital on the sidelines longer. The changes made this week are at odds with the Treasury Department's Public-Private Investment Plan as it potentially encourages banks not to sell their tradable assets to government-backed buyers but rather wait and hope that their valuations become reality should economic conditions improve.

G20 commitment to International Monetary Fund is positive for trade

While the FASB was hard at work at their headquarters in Connecticut, the leaders of the world's top 20 economies were meeting in London to try and cobble together a unified response to the financial crisis. In my view, perhaps the most significant measure to come out of the meeting was an agreement to strengthen the International Monetary Fund (IMF) by making $1.1 trillion in loans and guarantees available through the institution. The measure triples the IMF's lending resources, allowing it to provide greater assistance to countries—particularly in the developing world—at risk of being swamped by the global downturn.

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